REPLY

OF CANADIAN GOVERNMENT

TO

THE MEMORIAL ON BEHALF OF THE PREFERENCE AND COMMON SHAREHOLDERS

OF THE

GRAND TRUNK RAILWAY COMPANY OF CANADA

Letter from the Canadian Prime Minister to Sir A. W. Smithers, Kt. Chairman of the Shareholders' Committee.

61045

[PRIME MINISTER'S OFFICE]

OTTAWA, CANADA,

May 26, 1923.

Dear Sir ALFRED SMITHERS,

As a Government, we have been giving consideration to the Memorial of the Committee which appealed to us on behalf of the Grand Trunk preference and common shareholders. This whole matter is, as you know, an inheritance which the present administration received from its predecessor. The Government, therefore, considered it advisable in the public interest to secure a report on the claims of these shareholders from such Canadian Government and railway officials as had been continuously in touch with the proceedings attending the acquisition of the railways. The General Counsel of the Canadian National Railways, the Financial Vice-President of the National System, and the Assistant Deputy Minister of Railways were, because of their connection with the case both before and since the acquisition, requested to examine the Memorial and report the result of their investigation to the Government. This they have done, and I am enclosing, for the information of your Committee, a copy of their report.

We appreciate that this report will prove a disappointment to any who may have indulged unwarranted or unjustifiable hopes as to what Canada is in a position to do under the very difficult circumstances so fully dealt with by the reporting Committee. The Committee, while regretting the necessity for dealing so explicitly with and speaking so plainly regarding the conduct of Grand Trunk affairs by the previous Grand Trunk administration, have evidently felt that, in this particular, there was no alternative afforded them in view of the erroneous representations which seem to have been fostered abroad concerning the action and attitude of Canada with respect to Grand Trunk matters.

The Committee has dealt with facts as embodied in the records, and there would seem to be no question but that they have correctly stated the situation from the Canadian standpoint. I regret that, under the circumstances, it is not possible, therefore, to send a more favourable reply.

Yours sincerely,

W. L. MACKENZIE KING.

Sir ALFRED W. SMITHERS, Kt.,
Chairman of the Grand Trunk
Shareholders' Committee,
Knockholt,
Sevenoaks, Kent,
England.

REPORT OF THE CANADIAN COMMITTEE

OTTAWA, May 14, 1923.

Dear Mr. KING,

The undersigned, to whom you referred the Memorial on behalf of the preference and common stockholders of the Grand Trunk Railway Company of Canada, have given the representations contained therein careful consideration. The Memorial would appear to shed no new light on a matter which has been the subject of an extensive and costly arbitration, and a subsequent appeal to the Judicial Committee of the Privy Council. In neither instance has it been possible to achieve the object sought on behalf of the stockholders in question. Having failed on the arbitration and having failed in their appeal to the Privy Council which followed, the shareholders concerned now plead for what the late Sir Walter Cassels termed "equitable and moral consideration," though it must not be inferred that either Sir Walter Cassels or Sir Thomas White made any recommendation along compassionate lines.

The original offer of the Canadian Government was to take over the Grand Trunk and Grand Trunk Pacific Railways, by way of rental over a long period of years, renewable perpetually; to acquire all assets; and to relieve the Grand Trunk from its liabilities in respect of the Grand Trunk Pacific, and from its obligation to operate the National Transcontinental Railway; the Government "to assume other liabilities and obligations of both companies." In return, the Government offered to make an annual payment of $2,500,000 for the first three years, $3,000,000 for the succeeding five years, and $3,600,000 thereafter, these sums to be distributed by the Grand Trunk Management among the holders of 4 per cent guaranteed and other securities. The maximum sum named was the amount mentioned by the Drayton-Acworth report as the average dividend payment for the ten years preceding 1917.

FINAL AGREEMENT AND AWARD

This offer was not accepted, and after much negotiation and delay, an arrangement was made whereby the guaranteed stock was included with the bonded indebtedness, the interest on which was to be guaranteed by the Government; the other share capital—the preference shares and common stock—was to be acquired at a valuation to be determined by arbitration. This share capital was divided as follows:

First preference stock	£ 3,420,000	or	$ 16,644,000
Second preference stock	2,530,000	or	12,312,667
Third preference stock	7,168,055	or	34,884,534
Ordinary or common stock	23,955,437	or	116,583,126

The debenture stock, interest on which, under the acquisition agreement, was guaranteed by the Government, amounted to £31,926,125, or $155, 373, 808; the guaranteed stock of £12,500,000, or $60,833,333. The annual interest charge on these securities amounts to $8,988,633.77, and this sum is the extent of the Government's absolute guarantee in respect of the Grand Trunk acquisition. The guarantee of the Government

became effective, as provided by Section 3 of the acquisition agreement, on the appointment of the Joint Committee of Management, and this date, May 21, 1920, is the date as to which the value of the stocks at issue had to be determined. Under Section 11 of the same agreement, the amount of possible award was limited to $64,166,666.66.

The Majority Award

The majority of the Board of Arbitration—Sir Walter Cassels and Sir Thomas White—"after a mature deliberation and after careful consideration of the evidence adduced," held that there was no value to the holders thereof of the stock in question, having regard to the affairs of the Grand Trunk Railway Company of Canada, at the date of acquisition. Sir Walter Cassells held that potential value must be ascertained as if the Government had not come to the relief of the railway, and, in that event, he asked whether any sane business man with a knowledge of the facts could have arrived at any conclusion different from that come to by the former President of both the Grand Trunk and Grand Trunk Pacific, Mr. E. J. Chamberlain:

> "that a crash was inevitable, and insolvency and receivership the sequel," and Judge Cassels asked in that event, "would there be any reasonable chance of these four classes of stockholders ever receiving a cent on their investment? I think not."

Sir Thomas White held that the actual earning power of the railway "before, during and since the war, and so far as can be estimated for the future," did not justify the assumption that any profits would, from the date of acquisition, ever have been available for the shareholders in question, and, having regard to the continuing heavy deficits, the necessity for making provision for deferred and extraordinary maintenance and capital construction, and its heavy liabilities in respect of the Grand Trunk Pacific, the Grand Trunk Railway Company of Canada, but for the financial support of the Government since May, 1920, must have been forced into a receivership.

Judge Taft, in dissenting, declined to consider the value of the shares as of May, 1920, merely, claiming that the shareholders were entitled to a value then reflected by the prospect of a return to better conditions and an earning capacity within a reasonable period such as might not only meet fixed charges, but pay a dividend on the capital stock. "We have," said he, "a right to exercise our judgment as to when a normal condition of affairs will come, and on the basis of our judgment to judge the normal earnings in the future, by the normal earnings in the past."

Putting his contentions to the test of prophesy, Judge Taft went on to assume a revenue of $72,000,000 in 1921, and argued the probability of an increase to $90,000,000 five years after, or by 1926. He also assumed that by that time the normal operating ratio would be restored. By this he meant a net operating income of 25 per cent after taxes, uncollectable railway revenues, hire of equipment, joint facility rents, etc., were paid. This he states—(at page 59 of the award)—to have been the average net surplus of the Grand Trunk Railway company of Canada, for the seven years prior to 1917.

As already pointed out, the amount of possible award was limited by the agreement to 64 million odd dollars. Judge Taft appears to have taken that sum, made a 25 per cent reduction due to the five years' postponement of earning power, and placed the value at 48 millions accordingly. In doing so he discussed the position of the Grand Trunk aside and apart from its connection with the Grand Trunk Pacific. The other arbitrators pointed to the impossibility of considering the case of the parent road without due regard being had to its liabilities in respect of the subsidiary concern. At the outset of negotiations the Government of the day did offer to relieve the Grand Trunk of that liability on terms which were declined and which formed no part of the agreement finally concluded. The Grand Trunk could scarcely expect to have it both ways —to decline a proposal, agree to another, and then claim benefit of the first proposition. No one had any right or authority to consider the case of the Grand Trunk apart from the Grand Trunk Pacific.

The dissenting argument itself calls attention to the precarious condition of the Grand Trunk Railway. It contended that by 1926, it would likely be possible for the Grand Trunk to resume the payment of dividends. As dividends ceased to be paid following the extraordinarily good year, 1916, even Judge Taft's argument involved an hiatus of 10 years in the matter of dividends. He seemed to feel the desirability to bridge such a gap. "Had the Government not come to the rescue it is," he said, "quite possible that the bondholders, who had already come to the rescue in 1860, might have aided it again." The answer is that the bondholders were free at any time to have gone to the rescue of the Grand Trunk and its subsidiary during the period the Grand Trunk Management was urging the Canadian Government to take action.

Applying the Minority Finding

Judge Taft went on record as to the future of the Grand Trunk, more especially as to what likely would happen during the five years following the arbitration. Two years of the period thus dealt with have passed, and it is now possible to check up his predictions for 1921 and 1922. To avoid confusion, it should be explained that Judge Taft's figures are those of what is known as the Grand Trunk Railway Company of Canada, and not those as brought down in Parliament last year and this. The operating revenues and operating expenses of the Western and New England lines are not shown as such in the annual report of the Grand Trunk Railway of Canada which the British public is accustomed to. In that report, these American lines are treated as subsidiaries and only the net profit or loss appears, and that in income account. The figures produced in the Canadian Parliament have to be more plainly shown, and so the operating revenues and operating expenses of each of the three Grand Trunk lines and the Central Vermont are there shown separately (Hansard, March 27—page 1656). Contemplation of this new alignment of figures, which has appeared in the press on both sides of the Atlantic, easily might, and no doubt has, created the impression that the Grand Trunk Railway Company of Canada has made greater strides than it really has since it has been taken over.

Judge Taft assumed a total revenue for the Grand Trunk Railway Company of Canada of 72 millions in 1921, and a 5 per cent increase each year thereafter for five years. The total revenue of the Grand Trunk Railway Company of Canada in 1921 proved to be $76,858,032.27. To have kept pace with Judge Taft's hypothetical 5 per cent increase would have required a total operating revenue of $80,700,933.88 in 1922, whereas the actual operating revenue during that year was $77,700,019.23. The operating ratio, which was 92·61 in 1921, dropped to 90·50 in 1922. Judge Taft's conclusions are conditioned upon it reaching 75·00 by 1926. The operating expenses declined from $71,179,292.80 in 1921, to $70,317,-813.45 in 1922. To fulfil Judge Taft's prediction, they must be reduced to $67,500,000 by 1926 on an operating revenue of $90,000,000.

Judge's Taft's minority finding would add $1,920,000 to Grand Trunk interest charges. The annual interest on the old guaranteed stock is $2,433,333; so that the interest on the old and new guaranteed stock taken together in that event would be $4,353,333. As the maximum of the original offer of the Canadian Government was $3,600,000, it would mean the bettering of that offer by $753,333. On the other hand, it is $646,667 less than the maximum interest of $5,000,000 allowable "on the old and new guaranteed stock taken together," as provided by Section 11 of the acquisition agreement.

The revenue of 90 millions predicated by Judge Taft for 1926 amounts to $12,299,981 more than that of 1922, and the operating ratio would have to be such as to permit a net operating surplus of 25 per cent of that operating revenue, or $22,500,000. The Grand Trunk Railway Company of Canada made a net loss or deficit of $8,411,734.03 during 1922. Therefore, to meet the minority finding it will be necessary that the net operating revenue of 1926 be $30,911,734 better than the shewing for 1922. This is set out in order to show the distance still to be travelled before the conditions visualized by Judge Taft on September 7, 1921, can possibly be realized.

Unfortunate Plight of Small Investors

While due consideration has been given to the plea of the Shareholders' Committee, a stronger appeal is, as a matter of fact, contained in touching letters which the Government have received from individual shareholders, many of them aged, and, in varying degrees, dependent upon investments in Grand Trunk securities which they, in their faith in the Grand Trunk Management, did not in the least regard as speculative. Nor were those of them who invested life savings and small trust funds (for which they are by law personally responsible) aware that the market value of their investment was dependent upon dividends which, under proper methods of management and accounting, could not have been declared, and which, being declared, enhanced unduly the market for Grand Trunk shares. Unfortunately, it would not seem possible to make distinction between those who invested in good faith, and those who speculated with or without knowledge of what Judge Taft described as manipulation of the accounts of the company. Judge Taft said that this "dealing with accounts" by the London Management "admitted of no

defence," but ought not to be permitted to prejudice the interests of innocent shareholders. However, the latter should appreciate that the Grand Trunk Railway Company of Canada, though saved the actual ordeal of bankruptcy and all that that entails to shareholders, has nevertheless for some years been insolvent—unable to meet its own charges or those of its subsidiary, the Grand Trunk Pacific, which it abandoned when its Directors were told by Sir Thomas White, the Acting Prime Minister of the period, that they would have to determine their own responsibility for Grand Trunk Pacific charges.

Canadian Northern and Grand Trunk Common

Much reliance seems to be placed by the Memorialists on the payment to the Canadian Northern Railway of ten million dollars for sixty millions of common stock which, they say, represented no cash investment, whereas the preference and common stocks of the Grand Trunk represent an actual expenditure of $180,424,327.

The ten millions paid the Canadian Northern for the common stock referred to was on the award of a Board of Arbitration and was not granted on an appeal for compassionate consideration. The arbitrators were Sir William Ralph Meredith, Chief Justice of Ontario, Hon. Robert Edward Harris, Chief Justice of Nova Scotia, and Hon. Wallace Nesbitt, formerly of the Supreme Court bench, and (their award must be accepted as the conclusion of three of Canada's ablest men on a matter that admitted of great diversity of opinion.) While it is true it represented no cash investment, the Canadian Northern common stock did represent substantial potential value in a transcontinental railway under Canadian Management, strategically located, and favourably comparing in construction with the Grand Trunk Pacific. The Canadian Pacific Railway has clearly established the potential possibilities of such railways.

The Grand Trunk Railway of Canada was not a transcontinental railway, and had no such potential value. It had even abandoned to its fate its Western subsidiary and ally the Grand Trunk Pacific with which, however, it had no direct connection. Therefore, it did not stand to participate, as did the Canadian Northern, in the wonderful growth which may be confidently expected in Western Canada during the next 50 years. If the Grand Trunk common stock had any value surely 70 years of operation ought to have been sufficient to demonstrate it. As it had no value as a dividend-producer even in peak years of Grand Trunk activity, before and during the war—as, for instance, 1916, a year of big war business at pre-McAdoo wages and only moderately enhanced material costs, for which year Judge Taft claims a net surplus revenue of 32.88 per cent —(though he said " the Directors were trying to conceal it ")—it is reasonable to contend that as regards the Grand Trunk common stock the majority award of the arbitrators is just and reasonable. Further, the original offer of the Government, being based on the average dividend of the ten years preceding the Drayton-Acworth report, did not itself impute any value to the common shares, as they had not at any time participated in those dividends.

The Preference Shareholders

We regard the preference shares as in a somewhat different class, and are keenly aware of the fact that the preference shares are much more generally in the hands of the small investor who can ill afford the loss entailed by the mismanagement of Grand Trunk affairs. How gross this mismanagement was is becoming more evident as the new Management checks up the methods of the former Management. The original offer of the Canadian Government, which was declined by the London Management, would, at the maximum, have permitted the reasonable consideration of all shareholders except the common, who had never participated in a dividend, and which shares are reputed to be held largely for purposes of control. Full dividend payments at the rate of 4 per cent on the guaranteed stock, 5 per cent on the 1st and 2nd preference, and 4 per cent on the 3rd preference would have required a net surplus after fixed charges of $5,276,547, of which $2,433,333 would be interest on the guaranteed stock and $2,843,214 on the three preference stocks. But full dividends were an unknown quantity with the Grand Trunk. The guaranteed stock ranking first did very well until 1917 when dividends ceased, but the 1st preference shares had a less fortunate career, dividends being missed entirely in 1914 and 1915. A half dividend was paid in 1916 and again in 1917, the latter out of 1916 earnings, and out of moneys the late Judge Cassels declared were diverted from the payment of claims due the Government, and paid against the advice of the Grand Trunk's General Counsel that payments of such dividends would be "improper if not illegal." Since 1917 there have been no dividends declared or paid on 1st preference stock. Dividends on 2nd preference were missed in 1914, 1915 and 1916, a dividend paid in 1917 out of 1916 earnings and none paid afterwards. The third preference had 3 per cent in 1907, nothing in 1908 and 1909, ½ per cent in 1910, 1½ per cent in 1911, 2½ in 1912 and 1913, and nothing since.

What Might Have Been

As already stated, the average dividend payments for the ten years preceding 1917 amounted to $3,600,000. Had that offer been accepted by the English Management, there would have been, after 1928, a modified fixed dividend available perpetually for distribution to all excepting the common stockholders. A payment of 3 per cent on the guaranteed and the first and second preference and of 2 per cent on the third preference would have amounted to $3,391,389—well within the maximum offer. The balance, $208,631, could, if desired, have gone to the guaranteed stockholders, making their participation approximately 3 1-3 per cent. The proposal finally agreed to protected the guaranteed stock's full 4 per cent. By that arrangement, the guaranteed stockholders gained 2-3 of one per cent, and the preference shareholders lost everything. The preference shareholders are entitled to know why their interests were thus placed in hazard when the Canadian Government in its original offer was prepared to go so far towards their protection.

Position of the English Board

The Shareholders' Committee, whose petition is before the Government, is composed of the English members of the former Grand Trunk Board of Directors. They are seeking, on compassionate grounds, consideration they declined as a business proposition. This is stated not as a reflection on the judgment or motives of the former Management, but because of the necessity to place the responsibility for the plight of the shareholders where it rightly belongs. Should the shareholders wish more detailed information, we would recommend a critical examination of Judge Taft's reference to the London Management. The other arbitrators, also, were unsparing in their criticism of that Management, but we restrict our reference to the animadversions of the chosen representative of the Grand Trunk on the Board of Arbitration. After making certain admissions, he felt it necessary to point out—page 58 of the Award—that, "This is not a proceeding to penalize managers or directors of a company for false statements." But if the investing public was influenced to buy Grand Trunk shares by misleading statements, has the investing public no redress?

Recognition by the Canadian Government of the unfortunate preference shareholders would require Parliamentary sanction. The Canadian Parliament and Canadian tax-payers have recently been informed that the deficit on National Railways during 1922 was sixty million dollars! The burden of national debt on railway account is staggering, and clearly, those charged with the administration of the affairs of the country are in no position to be generous, either at the further expense of the tax-payers or at added cost to the National Railways. If the Executive of the Canadian National Railways are able by means of resident management and modern business methods to improve the financial position of the railways, they would scarcely regard with equanimity any proposal that the results of their efforts should be diverted to the remuneration of former shareholders who owe their unfortunate position to the former Management. We hope the English shareholders will be able to convince the former administration that it is their duty at least to take care of resultant cases of hardship. We feel that these unfortunate shareholders have a strong moral claim against the former Grand Trunk administration; as to the legal aspects, we do not presume to advise.

We have the honour to be, Sir,

Yours faithfully,

G. A. Bell,
Financial Vice-President,
Canadian National Railways.

Gerard Ruel,
General Counsel,
Canadian National Rys.

Geo. W. Yates,
Assistant Deputy Minister,
Department of Railways and Canals.

The Right Honourable
W. L. Mackenzie King,
Prime Minister,
Ottawa.